

What is a nonprofit?

A nonprofit corporation is a group of people who join together to do some activity that benefits the public, such as running a homeless shelter, an artists' performance group or a low-cost medical clinic.

A nonprofit corporation is a corporation formed to carry out a charitable, educational, religious, literary or scientific purpose. A nonprofit corporation doesn't pay federal or state income taxes on profits it makes from activities in which it engages to carry out its objectives. This is because the IRS and state tax agencies believe that the benefits the public derives from these organizations' activities entitle them to a special tax-exempt status.

The most common federal tax exemption for nonprofits comes from Section 501(c)(3) of the Internal Revenue Code, which is why nonprofits are frequently referred to as 501(c)(3) corporations.

All sorts of groups, from artists and musicians to people active in education, health and community services wish to operate as nonprofit (or not-for-profit) corporations. Often the reason for doing this is simple -- nonprofit status is usually a requirement for obtaining funds from government agencies and private foundations. Obtaining grants, however, is not the only reason to incorporate. There are two additional important benefits of forming a nonprofit -- tax-exempt status and personal liability protection.

In addition to qualifying for public and private grant money, most nonprofit groups seek nonprofit corporate status to obtain exemptions from federal and state income taxes. The most common federal tax exemption for nonprofits comes from Section 501(c)(3) of the Internal Revenue Code, which is why nonprofits are sometimes called 501(c)(3) corporations.

Forming a nonprofit corporation is very similar to forming a regular corporation: You must file "articles of incorporation" with the Missouri Secretary of State's Corporations Division. But, unlike regular corporations, you must also complete federal and state applications for tax exemptions – simply filing Missouri nonprofit incorporation forms does not make the organization tax exempt.

Stages of development

It is common for organizations to go through four distinct stages during start up. While it may seem easiest and most efficient to complete the entire start-up process at the onset of the new organization, many new nonprofits find it more manageable to grow slowly into their nonprofit status.

1. Many organizations start out as an informal organization. Your organization can continue with programs and activities informally as long as revenues do not exceed \$25,000 per year and the organization does not employ anyone.
2. As donations and activities grow, the organization may find a fiscal sponsor to aid with reporting requirements, administrative tasks, and to lend their tax-exempt status. This allows the organization to continue to focus its attention on programs.
3. An organization may then incorporate at the state level and maintain fiscal agency, or begin to establish itself on its own.
4. Finally, the organization may apply for tax-exempt status from the Internal Revenue Service. If accepted, the organization is now able to accept tax-deductible donations and is responsible following regulations set by the IRS and the state, and for reporting annually to the IRS, Secretary of State's Office, and Attorney General's Office.

As an organization goes through these stages of development, it may stop at any point and choose not to go further. Following these stages can allow your new organization to grow and succeed at its own pace.

Why Incorporate?

Not sure whether to form a nonprofit? Here's some information to help you decide.

If you're involved in a non-formal startup nonprofit organization and the members want to avoid being held personally liable for the activities of the organization, you would want to become a more formal organization by incorporating. Becoming a nonprofit corporation requires some paperwork, but for many groups, the benefits of nonprofit status outweigh the complications. Here are five circumstances that may make it worth your while to incorporate.

Your Association Makes a Profit From its Activities

If your group will make a profit from its activities, becoming a nonprofit corporation can yield a great benefit: As long as the money you make is related to your charitable activities, your nonprofit corporation won't pay income tax on it.

You Want to Apply for Public or Private Grant Money

Without tax-exempt status, your group is unlikely to qualify for many public and private grants. While you can form a nonprofit, tax-exempt association, rather than a corporation, qualifying for a tax exemption as an association is harder -- it requires preparing and adopting a complicated set of organizational papers and operating rules. Further, it's generally easier to get the IRS to approve a tax exemption for a nonprofit corporation.

You Want to Solicit Tax-Deductible Contributions

If your organization becomes a tax-exempt nonprofit corporation, donors can deduct their gifts to your group on their federal and state tax income returns.

You Want Protection From Personal Liability for the Group's Activities

If your group finds itself the target of a lawsuit, incorporation can provide welcome peace of mind. Nonprofit corporations can be sued -- but their members and directors are generally protected from personal liability, meaning that their own money, houses, cars or other property isn't at risk. That's not true of an unincorporated association.

Your Advocacy Efforts Might Provoke Legal Quarrels

Although nonprofits may engage only in very limited political advocacy (unless they elect to follow special federal lobbying rules), advocacy efforts may occasionally draw a nonprofit into an unwanted lawsuit. Incorporating can support directors and officers in defending the lawsuits and protect them from personal liability.

Additional Benefits of Organizing a Nonprofit

Although these aren't the main reasons people form nonprofit corporations, nonprofits can take advantage of other benefits, including:

- ◆ Special postage rates. Nonprofits can apply for and receive a mailing permit that gives them a special reduced nonprofit rate for mailings. This is especially helpful for organizations that will do a lot of solicitation by mail.
- ◆ Property tax exemptions. In addition to an exemption from income taxes, nonprofits are usually exempt from paying property taxes on real estate and other property. Contact your county assessor's office for more information on this property tax exemption, which is called a "welfare exemption."

Alternatives to starting a new nonprofit

While many people are tempted to incorporate first, there are a number of options for undertaking a new activity without starting a new organization.

Because most people thinking about starting a nonprofit have more passion for the purpose than the paperwork, it is wise to understand the ongoing reporting and record keeping requirements for

nonprofits. These obligations represent substantial time and financial requirements and can be an obstacle to success and an unwanted distraction for people wanting to spend their time directly involved in serving people, creating art, or promoting a cause.

Since many nonprofits are formed with high hopes and a few dedicated people and never get off the ground, investing time on the front end to determine the level of interest and availability of funds can help you better understand whether a new organization is needed.

Here are five alternatives to starting a new organization:

- Join an existing effort — Study the list of nonprofits already active in the same subject and geographic area and join their efforts as a volunteer, a board member or even as staff.
- Create a special program of an existing effort — Analyze the list of nonprofits already active in the same area, identify the three most compatible with your ideas, and meet with them to explore creating a special project or initiative and negotiate your involvement. You may have ideas that they would welcome, including resources that may be available to finance the new undertaking. Your activity could be a sponsored project with a level of independence, but without the need for separate books, government reporting and boards and committees.
- Start a local chapter of a national or regional organization — Explore the list of national organizations in the subject area of your interest, and see if a local chapter is needed in your geographic area.
- Maintain an informal organization — This is a viable option for groups with annual revenues under \$25,000 and no employees. If your focus will be quite local and small, consider forming an unincorporated association or club -- have meetings and activities but skip the ongoing reporting requirements. Informal organizations can operate as a nonprofit; however, donations to an informal organization are not tax-deductible. Those that choose to remain informal may undertake risk to board members and founders by not incorporating the organization. By incorporating, the organization becomes a legal entity and can only be liable for the assets of the organization. An incident involving an unincorporated organization may put personal assets of board members, volunteers, or others, at risk.
- Find a fiscal sponsor for your organization — If you are considering creation of a group to finance activities or needs of others, plan to work on a limited-time project, or want to test a program idea first, exploring fiscal sponsorship. Fiscal sponsorship, sometimes referred to as fiscal agency, is a way to receive tax-deductible contributions by using the tax-exempt status of another organization as an umbrella. The sponsored organization will pay a fee to the sponsor for their services, generally around 10 percent of the organization's revenues.

Fiscal sponsorship is a complex, individualized process. Organizations considering working with a sponsor should first identify several possible sponsors with missions in sync with that of the new organization. Work with each of these organizations to find the best fit in terms of missions, working style, and location.

It is recommended that both parties consult with legal professionals to ensure their interests are being met in the sponsorship agreement.

This information was developed using information from the St. Louis Volunteer Lawyers and Accountants for the Arts (www.vlaa.org), NOLO (www.nolo.com) and Minnesota Council of Nonprofits (www.mncn.org).